

The European banking regulatory framework in turning point – How are the evolving banking regulations reshaping banking business in the EU?

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<p>The recent global financial crisis has heavily reshaped the banking business around the world, especially during the past couple of years. All national banks within the European Union are influenced by decisions made on a global and on a European level, and many times it is failed to notice that the new banking regulations in terms of capital, liquidity, resolvability are not just endless red tape, but binding set of regulations that inevitably change the business environment where banks are operating. The banking sector in the European Union is in a turning point, as banks are forced to better understand and respond to the three growing sources of pressures – customers, investors, and regulators – all of them having diverse and even conflicting demands towards banks.</p> <p>The investigative research was conducted by collecting high-quality, secondary data online, including reports and memos by the European Union, articles and investigative reports from different respected institutions, and articles published by financial professionals in different newspapers. The evolving banking regulation sphere raises questions and varying opinions among financial leaders and especially within banks, and thus the topic could be viewed from multiple different point-of-views. This research provides an objective view on the current, demanding, situation banks are facing. The thesis is written in a consultative manner, to help all possible stakeholders understand the phenomenon and give some guidance how to adapt.</p> <p>The research tackles the question how the European banks are affected by the regulatory reforms, by investigating how banking regulation framework is formed in the EU and who are the regulators. In the end, one can learn how the European banks are affected by the regulative changes in reality. It is clear that the pressures from various sources are greater than ever before, and some banks fail to meet the new requirements. However, as the study shows, banks can also learn to identify the drivers behind the current regulatory changes and find new cost-efficient ways to improve their business models and this way comply with the new banking regulations.</p>	
Keywords Bank regulation, Basel framework, financial crisis, G-SIBs, capital, liquidity	

Table of contents

1	Introduction	1
1.1	Research problem and demarcation	1
1.2	Research methods.....	2
1.3	Thesis structure	2
1.4	Key concepts	3
2	Theory framework	7
2.1	Regulations as its own field of research	7
2.2	Safety-and-soundness regulations vs. compliance regulations	8
2.3	Bank failure theories	9
3	Regulatory framework in Europe – Who are the regulators?	11
3.1	European Commission.....	12
3.2	The European Banking Authority (EBA)	13
3.3	Bank for International Settlements (BIS)	13
3.4	Basel Committee on Banking Supervision.....	14
4	Banking regulatory framework in Europe – How is it working?	16
4.1	Establishing Banking Union.....	16
4.1.1	Key elements of the Banking Union	17
4.2	The Single Rulebook.....	18
4.3	Identifying global systematically important banks (G-SIBs)	20
5	The Basel Accords in the European Union	22
5.1	Development of Basel I and Basel II frameworks	22
5.2	Executing Basel III in EU.....	26
5.2.1	The Capital Requirement Directive IV (CRDIV)	27
5.2.2	The Capital Requirements Regulation (CRR).....	29
6	How are evolving banking regulations reshaping banks' business?.....	31
6.1	Conceptual framework	31
6.2	Changes in the business environment	31
6.3	What are “the three pressures”?	33
6.4	Balancing operations.....	34
6.4.1	The paradoxical pressure of banks towards its investors and regulators ..	36
6.4.2	New banking regulation and its impact on end-customers.....	37
7	Conclusion	40
7.1	The future of European banks.....	40
7.2	Own learning and relation to professional growth.....	41
	References	42

1 Introduction

The movie *What to Expect When You Are Expecting* tells a story of men and women in front of something new. The couples struggle with multiple questions when it comes to waiting for their first child to be born – so many questions, limited waiting period, and in the end coping with the reality. The movie might be telling a story of one's personal life, and seem very irrelevant in this context, but at the moment financial regulative reforms form the exact same question to banks and other financial actors: what to expect from the future when new financial regulation reforms keep emerging and there is no end in sight? It is clear that the ongoing changes in banking regulation are affecting all banks in Europe forcing them to reshape and optimize their current business models to planning supportive financial models. Banks need to find their way to keep on top with new emerging regulations and demands, find cost-efficient methods to implement any required changes in the operations, and finally being prepared for recovery and resolution actions in case of failure.

1.1 Research problem and demarcation

Financial regulations form a very complex topic that could be viewed from a number of different perspectives and could be researched to a great extent. I chose to focus my research on how the system of current financial regulative framework in Europe has developed from the 1970s to this day, having the main focus on the 21st century, and how the changes in business environment relate to the banks' operations today. I also had to make a clear demarcation on the concept "financial regulation" and chose to focus only on banking regulation leaving out the insurance sector that is also strongly regulated and partly even by the same organizations. If one thinks about the whole concept "regulation", it is clear that it has many interpretations. In this thesis the regulation is referred to as "a rule of order having the force of law, prescribed by a superior or competent authority, relating to the actions of those under the authority's control" (The Free Dictionary 2014). In this thesis the regulators are operating globally and at the European level, and thus their decisions are passed on to national supervisors.

There are a number of different regulatory reforms, but in this thesis the focus is on the development of current and upcoming regulations related to capital, liquidity, and solvability requirements imposed mutually for all banks in the European Union. Due to a strict demarcation, this thesis is not taking a stance on the operations of national supervisory

authorities, but is concentrating on the most important regulatory institutions or organizations affecting banking regulatory changes at the European level. The importance of these institutions is strictly the view of the researcher/writer.

1.2 Research methods

Research for this thesis is conducted by using qualitative descriptive research method. The topic fits well in the form of what, why, how, and when. My goal is to collect high-quality secondary data from various sources to form comprehensive picture of the current banking regulation sphere in the European Union and show the reader also how evolving banking regulations affect individual banks and their operations. The topic is widely debated and discussed due to hard economic times and continuous changes in banking regulations. The overflow of information sets its own challenges and makes it even more important to keep within the demarcated topic.

As also recognized by the European Commission, assessing the impact of regulations based on purely quantitative methods would be impossible. A memo by the Commission states that the full impact of financial regulations cannot be reliably assessed on quantitative basis, as the impact of regulations is impossible to isolate from other factors in economy, as well as from other changes in macroeconomics (European Commission Memo 2014, 3). Also, economic reforms, or sets of regulations, are targeted towards such market variables that does not provide accurate or publicly available data that could be benchmarked to the situation before regulative reforms.

1.3 Thesis structure

Figure 1 illustrates the structure of this thesis and the interrelation of the research question to the three investigative questions. The main research topic is evolving banking regulation framework in the European Union, and it will be discussed from two various perspectives – theoretical part concentrating on the regulative perspective (investigative questions one and two), and the empirical part briefly describing how evolving banking regulation affects the banks in reality (investigative question 3).

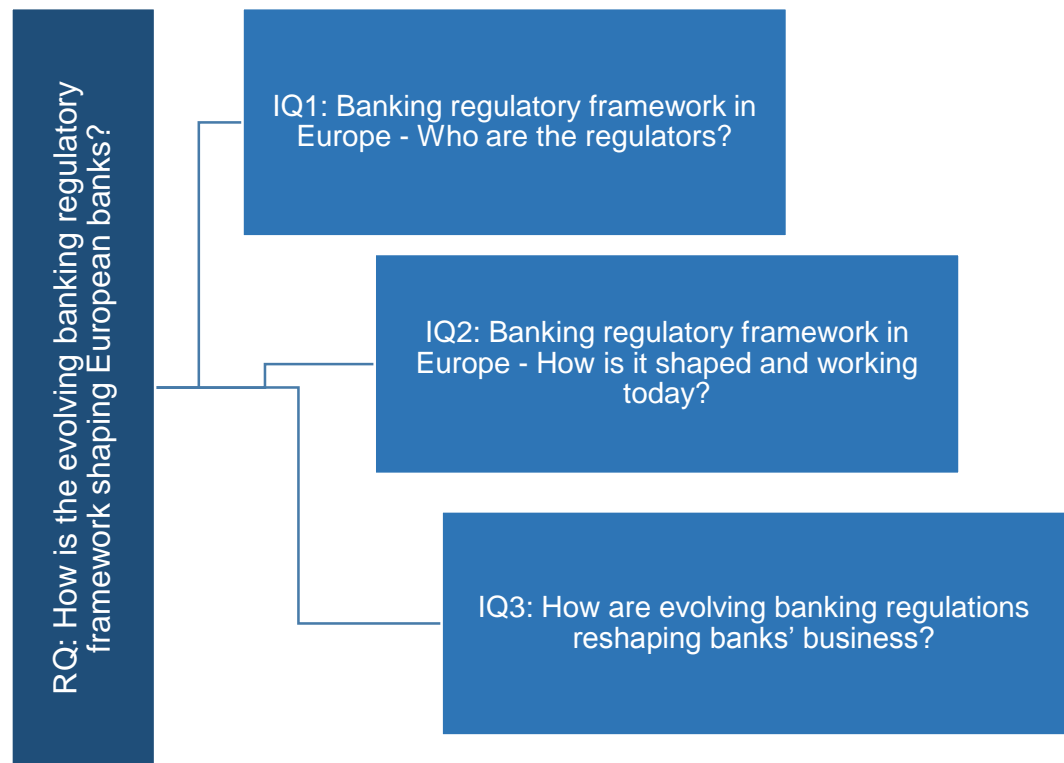


Figure 1: Research question and investigative questions 1-3

In the theory part, the reader will be introduced to the main economic theories affecting regulatory policy making. After introducing suitable economic theories, one will gain insightful view of who are the institutions responsible for designing, proposing, and implementing new banking regulations in European Union. These institutions or organizations I call regulators. After answering to the question “who”, I will present my view on how the banking regulatory system has developed to this day, and how regulations are being shaped today. Theory part reflects to the paradigm behind this thesis topic: the current banking regulation system is extremely complex and difficult to understand, but despite the complexity of it, it forms the core of banks’ operations.

After the theory part including economic theories and the representation of regulative institutions, the reader has a chance to see how evolving banking regulations affect banks’ operations in reality. Evolving bank regulation sets banks in front of new kinds of pressures towards their customers, investors, and regulators, and it is interesting to see the various effects it has.

1.4 Key concepts

Key concepts of this thesis include bank, bank regulation, banking regulation framework, regulator, capital, Tier 1 capital ratio, liquidity, resolvability, Global systematically important banks (also known as banks too big to fail), and the concept of “three pressures”.

In this section I will briefly identify each of the terms in order for the reader to understand their importance in relation to the thesis topic and scope. In addition I have listed explanations of some abbreviations that frequently appear in this thesis.

Bank

In this thesis a bank is referred to be a financial institution that holds a banking license and is thus able to receive deposits and grant loans. Bank in this sense includes commercial/retail banks, as well as savings banks (Investopedia 2014.)

Bank regulation

Bank regulations are “the laws and bureaucratic rules governing banking” (The Free Dictionary by Farlex, 2012). Term bank regulation raises many opinions and thus has various definitions, but in this thesis “bank regulation” is considered as a set of rules that call for maintaining confidence in banking and this way prevent failures that could cause future major damage to the overall economy at European level. Bank regulations are passed to banks at different levels by regulators, but in this thesis the concentration is on the global regulators passing the regulations down to national supervisors.

Banking regulation framework

The term “banking regulation framework” is used throughout this thesis to describe the broader aspect of banking regulations. As I studied the topic, it turned out that banking regulations on a European level never existed as discrete individual regulations, but as part of bigger entities concerning for example the required liquidity levels of banks to avoid bank failures. As an example of a banking regulation framework for EU we may use the new Basel III. It provides central banks a number of recommendable banking regulations concerning liquidity, capital adequacy, and stress tests, and thus forms a new banking regulatory framework. Regulators in the European Union then decide how the framework will be implemented on a European and national level, and how it will be passed on to individual banks.

Regulator

The official definition by Cambridge Dictionaries Online for financial regulator is “a person or organization that has been given the official job of making sure that banks, financial businesses, etc. act in a responsible way and do not break the law” (2014). In this thesis

financial regulator's definition applies also to bank regulator, but as the thesis is only considering bank regulation in European Union, the definition for regulator is limited to organizations regulating banks in the mentioned demographic area.

Capital

Capital is in a central role in this thesis as one main source of risk in the banking sector. Capital in this context means wealth that banks hold in form of cash or other assets, such as liquid securities or receivables. Capital also refers to credit and equity. In this thesis capital is linked to risks and regulations and thus I am using the European Commission's capital definition – "The accounting definition of capital is not the same as the definition used for regulatory capital purposes. For the purposes of prudential requirements for banks, capital is not obtained simply by deducting the value of an institution's liabilities (what it owes) from its assets (what it owns). (...) Only capital that is at all times freely available to absorb losses qualifies as regulatory capital." (2013a, 12).

Tier 1 capital ratio

Tier 1 capital is a concept describing bank's core equity capital, the backbone for capital adequacy. The Tier 1 capital ratio appears often in sources discussing banking regulation and means the ratio between the bank's core equity and their risk-weighted assets. Risk-weighted assets may be for example the letter of credits a bank is issuing (asset that holds credit risk). (Investopedia 2014)

Liquidity

Liquidity in this thesis refers to "a measure of the extent to which (...) organization has cash to meet immediate and short-term obligations, or assets that can be quickly converted to do this." (Business Dictionary 2014). Liquidity in banks is closely regulated and monitored.

Resolvability

Thomas F. Huertas has written a special paper with a topic "A resolvable bank". In the abstract he states: Making banks resolvable is a key component of the regulatory reform program enacted in response to the crisis. (Hurtas 2014, 1). According to Hurtas, "a resolvable bank is one that is "safe to fail": it can fail and be resolved without cost to the taxpayer and without significant disruption to the financial markets or the economy at large".

(Hurtas 2014, 1). In this thesis, resolvability follows the definition by Hurtas and supports the view that many new regulations are building both stronger but also more resilient banks in Europe.

Global systematically important banks (“Too Big to Fail”)

The Basel Committee has identified global systematically important banks (GSIBs) by their own assessment methodology. This definition means globally functioning banks that may seriously harm the real economy if their own business starts to weaken (Bank for International Settlements Publications 2013b). The same definition is parallel to the term “Too Big to Fail”. The concept reflects to the size, or other economic measures, of banks and to the illusion that due to a bank’s importance it would be immune to bankruptcy.

The three pressures

Represented first in the report by KPMG (2014). Banks face an increased pressure from and towards their customers, investors, and regulators. Evolving banking regulations gradually change the business environment where banks operate in through the modifying requirements customers, investors, and regulators pass for banks.

Abbreviations

EBA	European Banking Authority
BIS	Bank for International Settlements
SSM	Single Supervisory Mechanism
SRM	Single Resolution Mechanism
SRF	Single Resolution Fund
BRRD	Bank Recovery and Resolution Directive
DGSD	Deposit Guarantee Scheme Directive
CRD	Capital Requirements Directive
CRR	Capital Requirements Regulation

2 Theory framework

2.1 Regulations as its own field of research

Baldwin, Cave, and Lodge have brought up in *Understanding Regulation; Theory, Strategy and Practice* (2012), the issues of regulating and the nature of those issues that regulators and different institutions face. Their book deals comprehensively with the complexity of regulation in many fields of research – economics and political science among other multi-disciplinary fields. In this thesis, I will be concentrating in the economic regulation, but to understand the whole spectrum, it is good for one to understand the topic in a wider context.

Baldwin et al. argue in *Understanding Regulation*, we are living in an era of a “regulatory stage”. (2012, 2) By “**the era of regulatory stage**” the authors mean how theory and practice of regulation have become widely debated, researched, and at the same time accepted as its own field of research. According to the authors, regulation has matured as a general topic of debate in the past decade (2012, 1) and as a phenomenon it has naturally developed a clear division between sceptics and supporters. After making the research for this thesis, I could argue that the era of regulatory stage can also be understood as the inseparability of regulations in theory and practice. Today, it seems like there is no area in business without a touch of regulation.

Baldwin et al. define “sceptics” in this context as a group that regard regulation to be more “red tape” than anything else. Sceptics also often experience that regulations set a burden on economic activities and consequently regulations generally have a negative sound to them. ‘Supporters’, however, are defined as a group who sees regulations as practical tools that make rational control possible both in financial and social fields. (2012, 1)

It has been easy to notice the wide media coverage the regulation issue has gained during the past years. International organizations, especially European Union as one of the most influential institutions, have faced substantial criticism during the economic crisis. Baldwin, Cave, and Lodge state that regulation as a global phenomenon and as a single topic has prompted due to the economic hardships. This has also resulted in a greater division between supporters and sceptics who argue between deregulation and more rigorous touches in the financial field. (2012, 1)

2.2 Safety-and-soundness regulations vs. compliance regulations

Now we know that regulating in general arouses debate, but why are there so much debate on financial regulations if the main focus is to safe-guard economic stability for institutions as well as private consumers?

Bert Ely, a financial institutions and monetary policy consultant in Ely & Company Inc., writes about financial regulations in his article on The Concise Encyclopedia of Economics (Financial Regulation 2008). He names two divisions of financial regulations: safety-and-soundness regulations and compliance regulations. Regulations in these two sub-categories both aim to protect market and individual financial actors in the developed world, but from a different viewpoint. Ely differentiates safety-and-soundness regulations and compliance regulations by the nature of the financial actors they are protecting.

According to Ely, safety-and-soundness regulations within financial field concern depository institutions, such as banks, that “transform liquid liabilities into relatively illiquid assets such as home mortgages and car loans”. (2008). Ely argues that on the opposing side of depository institutions are their customers who can be considered to be “fixed-amount creditors”. In the article, Ely proposes that the main purpose of safety-and-soundness regulations is to protect fixed-amount creditors by ensuring solvency of the depository institutions and at the same time the overall stability of financial markets. Safety-and-soundness, or solvency regulations, tries to ensure that account holders and bank depositors will be protected from losses that would occur in case of bank’s insolvency. The stress is on **the prevention of insolvency** rather than on how to solve problems caused by insolvent financial institutions.

The other subcategory of financial regulations according to the article is compliance regulation. Ely refers to compliance regulations from the individuals’ point-of-view, but stresses how compliance regulations have become “a major responsibility for the regulators and a major cost burden for financial institutions.” (Ely, B. 2008). The article discusses how compliance regulations are to protect consumers from unfair treatment, but also to provide protection for institutions against external money-laundering threats. The article is written from an US-perspective, but European Union is also passing the same strict regulations on compliance to ensure transparency and stable business environment, as well as to avoid any criminal acts against banks and other financial institutions. Avoiding any money laundering acts is in a key position today, and compliance regulations as part of new

banking regulatory changes can be seen in banks as added reporting requirements to financial supervisors. Despite the ever-growing importance of compliance regulations, in this thesis I will be concentrating on safety-and-soundness regulations.

2.3 Bank failure theories

Charles Calomiris (2007) has written a working paper for National Bureau of Economic research in USA concerning bank failures. The paper deals with the history and theory behind bank failures and it provides an interesting viewpoint to support today's rigorous banking regulatory frameworks – especially regulations supporting banks' solvency. So how do bank failures and theories behind them support the current rigorous banking regulation sphere? If one thinks about the recent global financial crisis, it is obvious that no one in the public saw it coming. It was like a ticking time bomb behind the scenes, as large commercial banks had taken too much credit risk in lending. In the United States, home ownership was encouraged and the public had an easy access to take mortgages that were not backed by on an adequate level in the lending banks. Banks providing easy-access and high-risk loans were concentrating on a short-term profits and not on long-term value creation (Wikipedia 2014a). It was only a matter of time when this incautious trend would come to an end and it did peak in 2006 as a "housing bubble" in the U.S.A. According to the comprehensive investigative report by United States Senate (2011) high risk lending, regulatory failures, inflated credit ratings, and investment bank abuses were the four main causes for the financial collapse.

After the high risks taken by banks and the lack of capital to secure the risks transpired, "the values of securities tied to U.S. real estate pricing [started] to plummet, damaging financial institutions globally" (Wikipedia 2014a). The confidence of investors was at stake, as the solvency level of banks became questionable and the availability to take credit became harder. The stock markets started to plummet around the world and the economies and international trade took a great hit. The total collapse of a number of banks were prevented by large bailouts of national governments, but not without a cost – the financial crisis and global economic depression still continues today. (Wikipedia 2014a).

According to Charles Calomiris, new theoretical models suggest that even "banks that are intrinsically solvent are subjected to large unwarranted withdrawals and may fail as a consequence of this withdrawal pressure" (2007, 3). An important aspect to this theory is the panic approach. According to the paper, panic withdrawals and withdrawal pressures formed on the market by frightened depositors may result in a collapse of even a solvent bank. In addition to the panic-approach, Calomiris calls this theory as a "contagion" cause

of bank failure. His suggestion of banking crisis being “contagious” supports the above-mentioned development of the recent financial crisis. Due to global stock markets, international trade, fast electronic money transfers, and such, no bank, or economy, is safe from the negative effects happening on the market, if they don’t have safeguarded their business.

Calomiris also presents another approach to bank failures: fundamentals as causes of bank failures (2007, 3). This theory perhaps applies more to this day, whereas the panic-approach was more common for example during the Great Depression of the 1930s (Calomiris 2007, 5.) The author suggests that as opposed to the “panic” approach, the “fundamentalis” approach calls for “a chain of causation from non-panic-related, observable, exogenous adverse changes in the economic conditions of banks, to intrinsic weakening of bank condition, ultimately leading to bank failure” (Calomiris 2007, 6). The approach implies that even though banks would be passive responders to macroeconomic shocks, their decisions “to curtail the supplies of loans and deposits in response to adverse shocks” will “magnify economic shocks” (Calomiris 2007, 6). This is an interesting viewpoint that actually relates very closely to banks’ operations through pricing and credit rating, for example.

These two approaches – panic vs fundamental approach presented by Charles W. Calomiris – provide motives to protect banks, as no matter what the source of shock is, banks are seen as magnifiers of macroeconomic disturbance. (2007, 6) These bank failure theories also support the view that the size of a bank does not protect it from total collapse. Later in this thesis, one will be shown how the global systematically important banks, or “too-big-to-fail” banks, are identified today to add transparency and to remove the dangerous presumption that some banks would be too important to let them go bankrupt. As we learned from Calomiris’ bank failure theories, it not about saving a bank from the bankruptcy, but rather preventing the situation where banks would become insolvent.

3 Regulatory framework in Europe – Who are the regulators?

In this section I will be presenting four major institutions or organizations who are involved in reshaping the banking regulatory framework in European Union. The organizations I have selected is my personal viewpoint on the issue as a researcher and I selected them based on the organizations' importance and concrete regulatory reforms. During the research, I have noticed that to understand the whole spectrum of the current banking regulatory situation, it is crucial to know some history and background of banking regulations. This also includes understanding the structure of an organization and their major commitments. The four regulatory organizations I have selected are operating both on a global and European level. Even though this thesis is concentrating only on banking regulations affecting banks within the European Union, in today's global business environment banking regulations are very much the same in all developed countries. According to a memo published by the European Commission, the recent financial crisis has taught an important lesson how "enforcing the cooperation of monetary, fiscal and supervisory authorities across the globe is an absolute necessity." (2013a, 1).

The regulators, such as the Basel Committee on Banking Supervision, work globally together with central banks and national supervisors to implement new banking regulations. Banking regulatory sphere is extremely complex – global organizations guide area specific legislators, such as the European Commission in the European Union, and they again pass the legislation on to the national supervisors who ensure all banks within their national borders apply the new banking regulation. In the following graph I have collected the institutions I will be presenting, to give a quick glance on what levels they are operating.

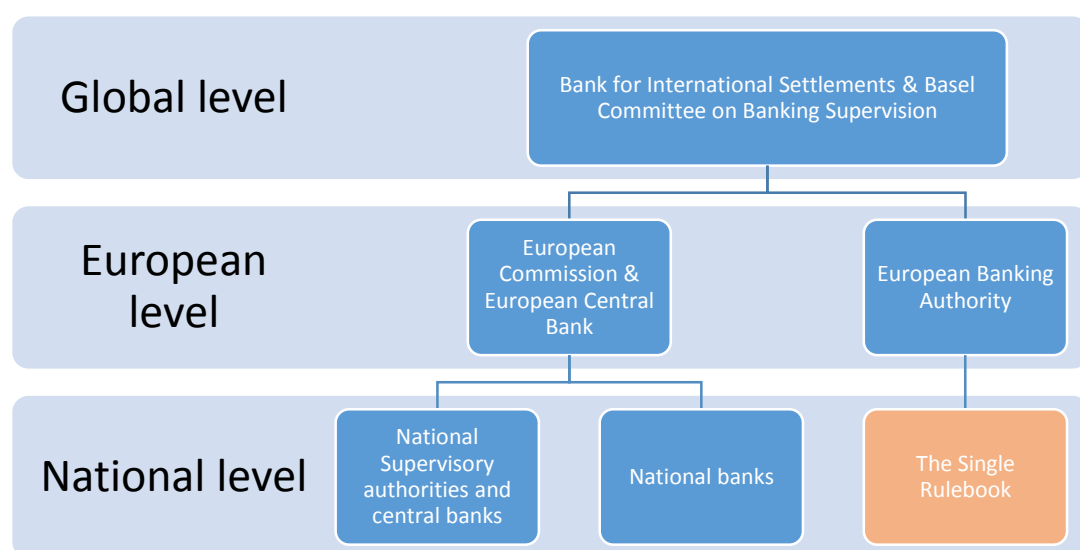


Figure 2: Different levels of banking regulation

3.1 European Commission

European Commission is contributing to the sustainable growth of European economy by four main objectives: creating and enforcing financial stability, financial integration, market integrity and confidence, and efficiency. These objectives also form the base for new reforms taken place within EU area (figure 3).

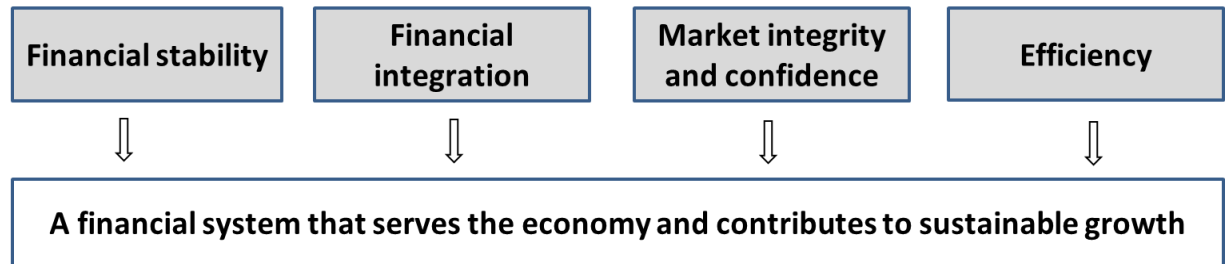


Figure 3: Overview of the reform objectives (European Commission 2014a)

Since the beginning of the financial crisis in 2008, the European Commission has passed on around 40 new proposals to commit to their mission of achieving financial stability and deeper integration. The initiatives are closely linked to the new financial regulatory framework developed by the G20. (European Commission 2014b) One can notice that almost all authorities and regulative organizations seem to have almost identical objectives when it comes to stabilizing the economy and recovering from the global financial crisis. This again might cause doubt in public – will the objectives really be accomplished? As a plea for the European Commission, one can say that the financial sector reform through new proposals has been successful, as almost all of the initiated proposals, or measures for the financial reform, have been adopted and are already in force. (European Commission 2014c)

Michel Barnier, a member of the European Commission in charge of Internal Market and Services, discusses in the leaflet *Financial reform at the service of growth* how taxpayers have been the victims of the latest financial crisis and that the new reforms proposed by the European Commission ensure that “citizens (...) do not again have to pay for the bad practices and excessive risks taken by banks” (2014c). Barnier stresses in the leaflet how it’s not only about the new stricter rules and regulations but also about greater global integration and supervision.

3.2 The European Banking Authority (EBA)

The European Banking Authority (EBA) is one of the most important and influential authorities in terms of promoting convergence in the financial regulatory field in the European Union's banking sector. It works as an independent EU Authority and its main task is the creation of the Single Rulebook for the banking sector. The Single Rulebook aims to be a set of harmonized standards for the banking sector operating within EU area to avoid any national disparities when implementing EU-wide banking regulations. EBA is also conducting supervisory activities to ensure banking regulations set in the Single Rulebook are implemented and thus depositors, investors, and consumers can be protected at the highest level possible. (European Banking Authority 2014) The Single Rulebook will be presented in more detail later on in this thesis.

The main difference between the EBA and other organizations represented in this thesis (excluding European Commission) is that the EBA can produce binding Technical Standards (BTS) that are legally binding and will be aspects of EU legislatives (directives or regulations) after being endorsed by European Commission . The EBA can also produce other non-regulatory documents, such as recommendations, opinions, and other regular reports to endorse transparency, fair market atmosphere, simplicity, and coherency. (European Banking Authority 2014)

3.3 Bank for International Settlements (BIS)

The Bank for International Settlements, more commonly known as the BIS, was founded in 1930 in Basel, Switzerland. It is considered to be the oldest international financial organization that nowadays provides various services and support for central banks and other monetary authorities all over the world (Deutsche Bundesbank 2014). It is also known as "the bank of central banks" as it provides wide range of financial services for central banks. This makes it an important cooperative body for Euro countries' central banks, as well as to the European Central Bank. The organizational structure of the BIS is extensive including associations, committees, secretariats, and other departments with specific core responsibility areas. Currently, there are sixty members in BIS and the members are either central banks or other monetary institutions, such as the European Central Bank (Bank for International Settlements 2014c, 2).

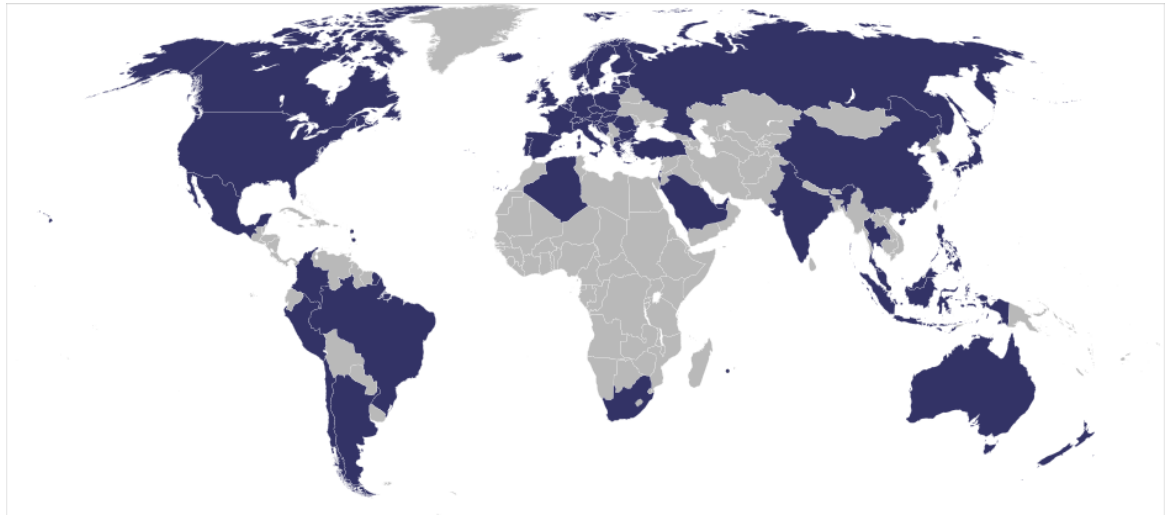


Figure 4: BIS members (Wikipedia 2014b)

The main focus for the work of the BIS is fostering financial and monetary cooperation with strong global aspect by promoting discussion, conducting research, and by acting as a primary counterparty in financial transactions between central banks. The main task is to act as an agent in fostering the financial stability and cooperation, but the actual facilitative process is done in its specialized departments and committees (Bank for International Settlements 2014c, 2). According to the Germany's central bank, Deutsche Bundesbank, the regular meetings at central bank governor level are important discussion hubs for dealing with the current financial market situation and issues concerning it (2014).

The BIS facilitates financial and monetary cooperation by its secretariats, such as the Basel Committee on Banking Supervision and the Committee on Global Banking Supervision. In the upcoming chapters, one will learn how the Basel Committee on Banking Supervision is contributing to the financial stability and how extensive their importance is in the global banking sector. In addition to these above-mentioned organizations, the BIS hosts a number of other secretariats and independent organizations, and works as an umbrella to the whole network of financial stability operators. Despite the demarcation of this thesis to only banking regulations, it is important to notice that the BIS is also maintaining stability in the insurance sector and together with the banking sector they form up the overall financial sector. (Bank for International Settlements 2014c, 3)

3.4 Basel Committee on Banking Supervision

The history of Basel Committee on Banking Supervision (initially known as Committee on Banking Regulations and Supervisory Practices) has its roots in the early 1970s. The Committee was established after few negligent incidents within financial field that resulted in heavy economic losses in international banking. In 1974 Bankhaus Herstatt lost its

banking license due to having three times more foreign exchange exposure than what the bank had capital in reserve. This caused international losses also outside the German borders. At the same time, a US-based bank, the Franklin National Bank of New York was forced to close down for the same reason. (Bank for International Settlements 2013a, 1)

Until 1974, banking supervisory activities were practiced by domestic supervisory institutions, but after the incident described above, G10 countries found that international committee was needed to protect international financial markets. The Committee on Banking Regulations and Supervisory Practices was established in February 1975 to form an open forum for discussion and to increase quality in global banking supervision. Original members included G10 countries, but today the Basel Committee on Banking Supervision is formed by 27 institutions, including central and national banks from all over the globe. (Bank for International Settlements 2013a). Basel Committee on Banking Supervision has no legal force, but the minimum requirements and recommendations designed for supervisory in finance are closely monitored and expected to be implemented by all Basel Committee members, or independent national authorities (i.e. national banks and other prudential supervision authorities). The work of Basel Committee is observed by many respected and well-known institutions. The stress on the observation is in the European financial market and the main observers today include the European Commission, the European Central Bank, the European Banking Authority, the International Monetary Fund and the Financial Stability Institute. (Bank for International Settlements 2013b, Appendix A).

Basel Committee on Banking Supervision is in the core of creating financial stability in the global banking sector by designing Basel Accords, or the comprehensive banking regulatory frameworks. Basel frameworks form the base for banking regulation reforms also in the European Union. According to the Basel Committee, the target is to create “resilience at the individual bank level” to reduce “the risk of system wide shocks” (Bank for International Settlements 2014d.) The actual work of Basel Committee, the Basel Accords, will be presented in the next chapter to give a sense of how extensive the “Basel process” is, and how the three Basel Accords have helped central banks and national financial authorities reshape banking regulations and supervision. The Basel Committee’s work is also the key pillar of current global debate on financial stability. (Deutsche Bundesbank 2014)

4 Banking regulatory framework in Europe – How is it working?

In the previous chapter, one was introduced to the four major organizations, or regulators, affecting the reformation of banking regulations in the European Union. In this chapter I want to demonstrate what kinds of actions are taken in order to create safer and more coherent banking system within European Union. I have collected here four key aspects that in my opinion form the base for more resilient banking sector within EU. As proposed earlier, creating coherent banking regulation sphere in such an economically diverse area as European Union is not an easy task and thus it has to start quite far from individual banks. After researching the issue, I found that European Union is truly pushing hard to achieve new kind of financial stability by creating new regulative mechanisms, and using these mechanisms for implementing banking regulations more effectively in the whole European Union area. In this section I will move from grass roots level of establishing banking union in European Union, to explaining how the Single Rulebook is used as a tool in the application of new banking regulations in all European banks. After that, I will move to more detailed information on how banks are categorized by their influence to the overall economy and how the categorization affects banks in terms of new required safety measures and capital buffers. In the end of this chapter, I will present the development of a very important global banking regulatory framework called the Basel Accords.

4.1 Establishing Banking Union

The need for establishing a common Banking Union in Europe became clear when the global financial crisis hit the Eurozone harder than many other economic areas. In 2012, it was agreed by a number of EU institutions that a banking union would be created to support the economic and monetary union, and to enforce centralized application of EU-wide rules for the financial sector. The new regulatory framework for the Banking Union is to cover all banks in the Euro area and thus there need to be a strong supervisory authority appointed for it. European Central Bank (ECB) was appointed to be in charge of the overall supervision of the new banking union. ECB will take on the task from the beginning of November, 2014. To prepare ECB for the task and to gain a truthful and timely picture of the Eurozone banks' financial health, comprehensive assessments are currently being carried out by different EU institutions (European Commission 2014d, 2). According to the 10 October 2014 press release by the Finnish Financial Supervisory Authority, the assessment of financial institutions has been completed and the assessments included a total of 130 euro area banks, including Finnish banks such as Nordea Bank Finland Group, OP-Pohjola Group and Danske Bank Plc Group.

The new financial supervisory mechanisms are being built in a whole new way so that the European Central Bank will be in charge of the supervision of all Eurozone banks – either directly or through national supervisors that will support ECB in the supervisory task. According to the Finnish Financial Supervisory Authority (Fiva) the above-mentioned assessment was “undertaken as a risk-based review of the balance sheets of the banks that are due to come under direct ECB supervision” (Financial Supervisory Authority 2014).

4.1.1 Key elements of the Banking Union



Figure 4: Key elements of the Banking Union

The two key safety pillars in the Banking Union (Figure 4) are the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM) (Feelingeurope.eu 2014). The supervisory and resolution mechanisms provide the Banking Union with an opportunity to comprise centralized supervision and a centralized resolution regime that all financial actors in 28 Member States in the European Union must comply. (Freshfields Bruckhaus Deringer 2014) The idea behind the new Banking Union is to move from having the risk of failing banks on tax payers to creating new, European wide, safety net in form of a Single Resolution Fund. (European Commission 2014d, 1-2).

As mentioned earlier in this thesis, Bert Ely has suggested that there are two categories of financial regulations: safety-and-soundness regulations and compliance regulations. (Ely 2008) Banking Union represents both of these regulation categories, as compliance issues are covered by the Single Supervisory Mechanism and the safety-and-soundness regulations are included in the Single Resolution Mechanism. The Single Resolution

Mechanism includes a new Single Resolution Fund (SRF) that is used in case of executing any bank resolutions (Pwc 2014).

The Single Supervisory Mechanism (SSM) is one of the two current key elements of the Banking Union. The SSM legislative package was adopted in September 2013 by the European parliament and it contains specific tasks related to banking supervision and financial stability. The approved SSM package includes a Council Regulation that will give the power for supervision for the European Central Bank. The SSM Regulation is consistent with the existent EU regulatory framework and concerns the daily tasks of banking supervision, as well as some powers to practice early intervention if a bank is breaching regulatory requirements. (European Commission 2013)

Whereas the SSM regulation sets out the general supervisory acts for the European Central Bank, the Single Resolution Mechanism (SRM) defines the common procedures and assessment criteria in the case a bank within the Eurozone needs to be put into the resolution process. The resolution mechanism is needed to avoid any possible financial damage to the overall European economy. All Eurozone banks are involved in the SSM and SRM procedures, but also other EU Member States may opt into the mechanism. One key aspect of the SRM regime is the forming of a new Single Resolution Fund (SRF). According to the analysis of PwC, the SRF is not to be used as bailout fund for troubled banks, but rather a “lubricant” in the resolution process to finance the use of resolution tools. (PwC 2014, 9) The Fund is still in the development process together with other aspect of the SSM and SRM regime, but it’s important to notice how the earlier trust-based Eurozone is developing towards much more regulated and systematic entity in the following years.

4.2 The Single Rulebook

In the previous section, one was introduced to the Banking Union and to the mechanisms that are used to achieve the Banking Union’s targeted goals. The Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM) also relate to the Single Rulebook, as can be seen in the Figure 5 below. The Single Rulebook is meant to work as a key tool to achieve safer and sounder post-financial crisis market within European Union. The Single Rulebook consists of initiatives that are **common to all financial actors operating in the EU** area. Restoring financial stability calls for “stronger prudential requirements for banks, improved depositor protection and rules for managing failing banks” and together these rules and regulations form the Single Rulebook. According to the European Association of Co-operative Banks, the new rules set common requirements for

“higher ratio and the better quality of capital, introduce additional capital buffers, enhance governance and introduce new ratios regarding liquidity and leverage” (2014).



Figure 5: Single Rulebook for the European Single Market (EACB 2014)

The Single Rulebook covers common capital requirements, resolution mechanisms, and deposit guarantee schemes. The Capital Requirement legislative package in the Single Rulebook includes the new **Capital Requirements Directive IV (CRDIV)** and **Capital Requirements Regulation (CRR)** provisions that implement the global Basel III agreement in the European Union. By EU passing CRRs directly, it will avoid any national divergences that passing directives would cause when implementing directives into national legislation. CRR implementing Basel III in the European Union requires no further actions from national authorities and thus it supports the view on having one “single rulebook” for banking regulation across the EU. (Rating Focus 2014)

The prevention of future financial crisis is seen as the base for new, enhanced financial regulations for banks, but the recovery and resolution of banks is taken into account. Dirk Schoenmaker and Daniel Gros have been investigating the current Eurozone banking system and some threats that the European banking sector is facing. In their CEPS working paper – A European Deposit Insurance and Resolution Fund – they aim to promote discussion and debate concerning the current system and how to build a European wide safety net for cross-border banks. Schoenmaker and Gros have described the European banking sector in their working paper by quoting Mervyn King, the Governor of the Bank of England, saying that “banks are international in life but national in death” (2012, 1). One of

the principles of a good safety net is that it has sufficient geographical reach. As stated by Schoenmaker and Gros (2012, 2), “To foster the stability of banks, the safety net should have the same geographical reach as the main activities of a bank. So European banks need a European safety net”. The working paper states there is a need for a proper safety net, especially in Europe, as cross-border banking cannot be efficient and/or stable when weak domestic banking systems threaten the whole European-level banking system. (2012, 1).

In the Single Rulebook, Schoenmaker and Gros’s call for safety net has been answered when resolution and guarantee schemes have been harmonized on a whole European level. **The BRRD, the Bank Recovery and Resolution Directive**, ensures that resolution authorities are established in all member states with the dedication to cooperate with European authorities to prevent failing banks. The Directive will also introduce the new framework for resolution mechanism with three aspects: prevention, early intervention, and the resolution of failing banks. (European Association of Co-operative Banks 2014) **The Deposit Guarantee Scheme Directive (DGSD)** of the Single Rulebook requires all national banks within Eurozone to cover individual depositors’ deposits in banks up to €100.000 instead of the earlier €20.000. This Directive is meant to harmonize the guarantee scheme across the Euro area and protect depositors in case of an insolvent credit institution, and also to minimize the risk of “panic withdrawals” that could strongly harm the overall financial stability. (European Association of Co-operative Banks)

4.3 Identifying global systematically important banks (G-SIBs)

One of the most important engagements Basel Committee on Banking Supervision has been concentrating since the beginning of the latest global economic crisis in 2007, is the creation of a systematic methodology for identifying global systematically important banks (from now on referred to as G-SIBs). The methodology was created in 2011 and it was revised in 2013 to meet the current needs. (Bank for International Settlements Publications, 2013a)

Identifying G-SIBs is important to prevent a repeat of the global financial crisis, as the G-SIBs play a central role in the financial market. Accenture explains in their Basel III handbook that finding the sufficient level of capital for each bank is important. According to the Handbook, the latest financial crisis showed that insufficient, poor quality and also non-available (illiquid) capital was the reason many institutions weren’t able to tackle losses as they occurred, and this led to even a bigger crisis. (Accenture 2012)

The assessment methodology assesses banks and their global systematic importance in terms of the “impact that a bank’s failure can have on the global financial system and wider economy” (Bank for International Settlements Publications 2013b, 5.) In more practical terms, the greater global impact a bank holds towards the overall economy, the greater safety buffers it needs. The assessment of banks is done by using a five-sector indicator-based measurement approach developed by the Basel Committee on Banking Supervision. The five indicators for which banks are calculated scores are: **cross-jurisdictional activity, size, interconnectedness, financial institution infrastructure, and complexity**. (Bank for International Settlements Publications 2013b, 5)

Michael Beaton explains in his article “Updated G-SIB methodology highlights importance of data” (Economonitor 2013) how exceeding the pre-determined cutoff levels for each indicator brings the bank closer to being identified as a Global systematically important bank. Beaton adds that the overall score is calculated by taking a simple average of the above mentioned five-category scores. All G-SIBs are then allocated into five equal-sized buckets based on the banks’ scores in the assessment. (Economonitor 2013) As illustrated in the Figure 6, each bucket has a specified higher loss absorbency requirement as a percentage. Banks that are placed into bucket four and five correspond the highest importance to the overall economy in case of the bank’s failure. As of November 2013, HSBC and JP Morgan Chase are in the bucket four, bucket five being empty. As the list of G-SIBs is updated every year, the allocation in the buckets may also change if there are some major changes in the bank’s business.

Bucket	Higher Loss Absorbency Requirement (common equity as a percentage of risk-weighted assets)
5	3.5%
4	2.5%
3	2.0%
2	1.5%
1	1.0%

Figure 6: Buckets for higher loss absorbency requirements (Beaton 2013)

As an example of a G-SIB company is Nordea Bank (Financial Stability Board Publications 2013, 3). In practice it means Nordea has been assessed by using the indicator-based measurement approach developed by the Basel Committee on Banking Supervision and the bank has exceeded the cut-off levels in some or all of the following categories: cross-jurisdictional activity, size, interconnectedness, financial institution infrastructure, and complexity. The average score for Nordea Bank is above the cutoff-level, and

thus it is considered a global systematically important bank, a G-SIB. Nordea Bank is assessed to fall into the first bucket, meaning the bank is required to implement a 1.0% higher loss absorbency rate for capital than a non G-SIB. This is to be done in January 2016 at the latest (Financial Stability Board Publications 2013, 1.)

5 The Basel Accords in the European Union

The Basel Accords – Basel I, Basel II, and Basel III – form a set of banking regulation recommendations that banks are encouraged to follow (Wikipedia 2014b). As the term ‘recommendation’ suggests, they are not legally binding as such, but for example within the EU area, Basel regulations are implemented in the EU community law after being viewed, possibly modified, and then approved by suitable EU bodies. European Central Bank published an Occasional Paper in 2005 that discussed the adoption of Basel II into EU legislation. The Abstract of the paper states that “Although the EU rules are to a large extent based on the texts of the Basel Committee, modifications have been introduced to account for the specific legal and institutional setting, as well as for some features of the European financial system” (Dierick, Pires, Scheicher & Spitzer, 5). In this section, I have collected the important aspects and development of Basel I, Basel II, and Basel III, to give a sense of how mitigating banks’ credit, market, and operational risks are handled in EU through Basel Accord. Due to the generality of the information I will be presenting here, I have mainly used information provided by the Basel Committee.

5.1 Development of Basel I and Basel II frameworks

The main focus for the Basel Committee’s work since the early times has been on ensuring adequate capital in financial institutions and by this strengthening the overall stability of international banking system. To do this, the Basel Committee has been developing Basel I and Basel II frameworks that have evolved over time, and currently Basel III is in the development and implementation process.

History of Basel

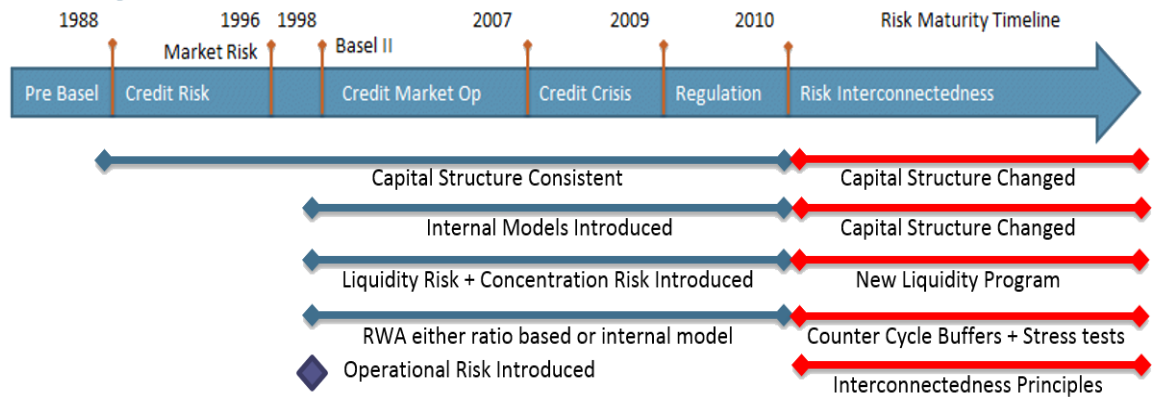


Figure 7: History of Basel (Causal Capital 2012)

In 1988, the measurement system for adequate capital requirements developed by the Basel Committee became known as **the Basel Capital Record (also known as the Accord)** and it was published around the world to be used in international banks to meet the minimum capital ratio to risk-weighted assets of 8%. According to the Bank for International Settlements, the Accord was to “work towards greater convergence in the measurement of capital adequacy” and by this remove any source of inequality caused by differences in national requirements around the world. (Bank for International Settlements, A brief history of the Basel Committee 2013, 2)

The first Basel framework, The Accord, was redefined in the 1990s by several amendments including clearer definitions to help with capital adequacy calculations and risk-recognition. In 1996, a major amendment was made to the 1988 Accord as market risk was included in the framework. Before this, the framework had concentrated only on credit risks arising from the “changes in value associated with unexpected changes in credit quality” (Duffie & Singleton 2003, 3). With the inclusion of market risk in the Accord, the Basel framework took a whole new dimension in the risk measurement and control. Market risk can be defined as “the risk of unexpected changes in prices or rates” and this can cause unexpected volatility and changes in the performance of different securities. (Duffie & Singleton 2003, 4)

In 1999, Basel Committee proposed to issue a new framework to replace the 1988 Accord. The Accord was replaced in 2004 by the Revised Capital Framework, today known as the Basel II, and it included a number of changes and improvements prepared over a six-year consultancy period. In the Revised Capital Framework, the importance of governing and revising especially the capital requirements for “internationally active banks” became much more central than before. (Bank for International Settlements 2006, 1) In addi-

tion to the improvements, the revised version also includes elements from the 1988 Accord that the Commission wanted to keep and thus the Basel II is a sequence to the Basel I framework.

The new framework is based on three pillars, which were developed based on a thorough research with experts in global banking sector, central banks and in external observer institutions and organizations. (Bank for International Settlements 2013a, 3.) The three pillars, that form the base for the Basel II, are presented in the Figure 8.

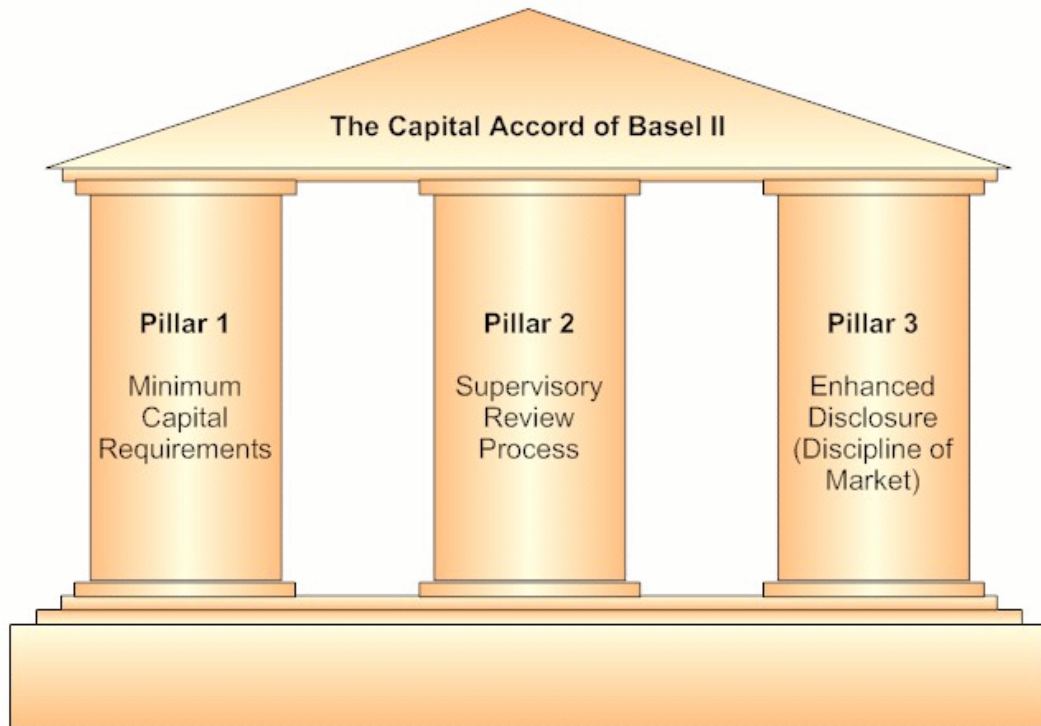


Figure 8: The Capital Accord of Basel II (Noweco, 2007)

The first pillar in Basel II sets out the minimum capital requirements to manage credit risk, market risk, and operational risks. The calculations define the minimum capital requirements to cover credit, market, and operational risks based on capital in Tier 1 (core capital) and Tier 2 (supplementary capital). As stated in the previous chapters, the inclusion of market risks only became viable in the 1996 amendment. Now, the Basel II does not only recognize credit and markets risks in the capital requirements, but also the operational risks. (Basel Committee on Banking Supervision 2006a, 12; 14) European Banking Authority states that operational risks are included in the EU legislation and they are defined as financial risks that stem from “inadequate or failed internal processes, people and systems or from external events.” EU legislation clarifies that operational risks include legal risks but exclude reputational risks and that operational risks need to be “embedded in all banking products and activities.” (EBA, Operational risk 2014)

The second pillar concentrates on the key principles of the supervisory review. Basel Committee describes Pillar 2 in the Comprehensive Version of the Revised Framework as follows:

This section discusses the key principles of supervisory review, risk management guidance and supervisory transparency and accountability produced by the Committee with respect to banking risks, including guidance relating to, among other things, the treatment of interest rate risk in the banking book, credit risk (stress testing, definition of default, residual risk, and credit concentration risk), operational risk, enhanced cross-border communication and cooperation, and securitization. (Basel Committee on Banking Supervision 2006a, 204.)

The Committee stresses that the supervisory review is a two-fold entity: it is meant to ensure the adequate capital to support risks involved in the business and also to encourage banks to develop strong and comprehensive risk management processes. The Committee has recognized four key principles for the supervisory review that are guiding not only the supervisory authorities, but also bank's internal processes to meet with the required risk management standards.

The second Pillar also identifies some additional issues and risks that should be taken into consideration in the supervisory review. These risks are not directly addressed in the Pillar 1. The section provides additional guidance to supervisory authorities to assess whether the calculations conducted in the Pillar 1 for adequate capital requirements are enough to cover the risk exposure in some exceptions. (Basel Committee on Banking Supervision 2006a, 212) The business environment, infrastructure, and possible special characteristics should be the basis for the review of the risk exposure.

The third pillar of Basel II is designed to complement the first two pillars by providing guiding principles for banking supervisory authorities acting on a national and international level. Supervisory authorities can demand the bank to disclose additional disclosure requirements under safety and soundness grounds (Basel Committee on Banking Supervision 2006a, 226). The disclosure requirements in the Pillar III are additional requirements to the general accounting requirements and they are designed not to conflict with broader accounting disclosures. Thus "the Committee intends to maintain an ongoing relationship with the accounting authorities" (Basel Committee on Banking Supervision 2006a, 227). Part 4 in the Comprehensive Version of the Revised Framework explains how Pillar 3 constitutes to the Basel II:

The purpose of Pillar 3 — market discipline is to complement the minimum capital requirements (Pillar 1) and the supervisory review process (Pillar 2). The Committee aims to encourage market discipline by developing a set of disclosure requirements which will allow market participants to assess key pieces of information on the scope of application, capital, risk exposures, risk assessment processes, and hence the capital adequacy of the institution. The Committee believes that such disclosures have particular relevance under the Framework, where reliance on internal methodologies gives banks more discretion in assessing capital requirements. (Basel Committee on Banking Supervision 2006a, 226.)

5.2 Executing Basel III in EU

We have now gone through the Basel I and Basel II frameworks, and one might be wondering why is there still needed a third amendment to the same Basel Accord? I was studying the issue and found that there is a clear reasoning to support the third amendment according to the European Commission. Based on Commission's memo from 16 July 2013, there are **three important lessons** that are learnt from the recent global financial crisis. Firstly, the cooperation between global monetary, fiscal, and supervisory authorities is a necessity, secondly the quality of capital and corporate governance outperforms the capital levels, and thirdly the failures of international financial groups need to be resolved on a cross border context and not on a national level. (2013a, 1-2).

The European Union is actively participating in the discussion forums in the Basel Committee on Banking Supervision to address the European banking specificities, as well as actively participate in the developments regarding the new capital, liquidity, and leverage standards. (European Commission 2013a, 4). European Commission stresses in their memo (13/690) that there are two important reasons that prevent European Union from just “copy/pasting” the Basel III into EU legislation. Firstly, the Basel regulations are not a law, but a set of international standards and strong recommendations. Secondly, the Basel regulations as such only apply to certain banks with “international activity”. However, European Union wants to apply the capital, liquidity, and leverage standards, as well as other enhanced requirements, in all banks and investment institutions within European Union. These two reasons are why Basel III needs to go through a comprehensive “democratic control as it is transposed into EU (and national) law”. (European Commission 2013a, 4.)

Due to the willingness to make Basel III standards fit in the European legislation regime as well as possible, Basel III regulations are applied throughout European Union by binding

Capital Requirements Directive IV (CRDIV) and the **Capital Requirements Regulation (CRR)**. The CRDIV/CRR were both briefly introduced in the chapter 4.2, the Single Rule-book, but in this section the reader will gain more insightful picture on what these provisions and regulations truly hold in. One will also learn how the Directive and Regulation execute Basel III framework in Europe in terms of capital and liquidity requirements (Pillar 1), supervision and risk-management (Pillar 2), and market discipline (Pillar 3), as illustrated in the Figure 9 below. In short, Basel III proposes to make banks stronger by requesting banks to have better and more capital, more balanced liquidity, and a leverage back stop. (European Commission 2013a, 3.)

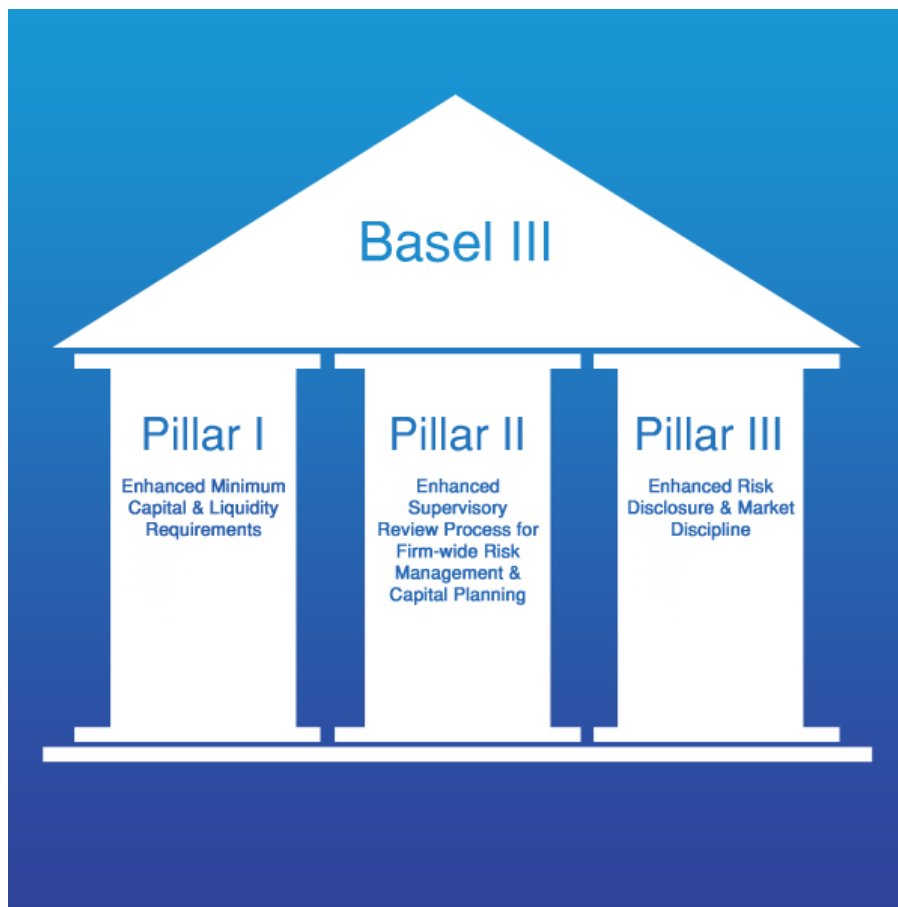


Figure 9: Basel III (Finsbury Solutions 2014)

5.2.1 The Capital Requirement Directive IV (CRDIV)

As stated in the EU law, directives are goals that all EU member states need to achieve by implementing them into their national legislation. Directive sets more freedom for national legislators, as it is up to them how the directive is implemented into the national legislation, as long as the goals are achieved. The Capital Requirement Directive IV, also called CRDIV, has **six important aspects** national legislators need to consider. They are:

remuneration, enhanced governance, diversity, enhanced transparency, systemic risk buffer, and other systemic institution buffer. (European Commission 2013a, 3.)

As can be seen from the nature of the six different aspects, the stress on the CRDIV is on having more compliance in the internal processes in banks. The directive has a clear stance on the second pillar of Basel III that aims to strengthen the supervisory processes and firm-wide risk management and capital planning. CRDIV states for example that to regain the trust of EU citizens in the financial sector, the transparency as regards of profits, taxes and subsidies in different jurisdictions in banks needs to be added (European Commission 2013a, 5). This means that banks operating in multiple countries need to publish the information concerning profits and taxes to the public in all countries they operate in. New requirements for disclosing information on remuneration has a strong link to transparency – the remuneration of staff members that have a link to risk taking (i.e. senior management and staff in charge of control functions) has to be reported on. This aims to recognize if the remuneration of such staff members in charge of risk taking is on an acceptable and rightful level. (European Commission 2013a, 29). Corporate governance is also an important aspect of the new CRDIV. According to the European Commission memo 13/690, enhancing corporate governance should help individual banks to avoid excessive risk-taking and thus the accumulation of excessive risk in the financial system as a whole (2013, 27).

Directive (Strong links with national law, less prescriptive)	Regulation (Detailed and highly prescriptive provisions establishing a single rule book)
Access to taking up/pursuit of business	Capital <ul style="list-style-type: none"> • Capital reserve equal to at least 8% of risk-weighted assets <ul style="list-style-type: none"> ◦ Minimum requirement for Tier 1 capital: 4.5%
Exercise of freedom of establishment and free movement of services	Liquidity <ul style="list-style-type: none"> • Liquidity Coverage Requirement (LCR) • Net Stable Funding Requirement (NSFR)
Prudential supervision	Leverage <ul style="list-style-type: none"> • Reducing leverage ratio • Legislative proposal in progress
Capital buffers	Counterparty credit risk
Corporate governance	Large exposures
Sanctions	Disclosure requirements

5.2.2 The Capital Requirements Regulation (CRR)

Whereas Directive is less descriptive and is to be implemented into national law by national legislators themselves, the Regulation is a binding EU-wide law that is enforced as such. The Capital Requirements Regulation, CRR, is enforcing Basel III by setting clear requirements for banks operating in EU in terms of capital, liquidity, leverage ratios and such. It is a very detailed regulation and it will be fully implemented by 1 January 2019 (European Commission 2013a, 15). The CRR implementation timetable is parallel to the implementation timetable of Basel III.

CRR sets clear requirements for banks' capital: the total amount of capital needs to be equal to at least 8% of risk weighted assets. In other words, the more risky assets (i.e. risky loans, complex finance arrangements, investments in venture capital firms) the bank holds, the more it is required to hold capital. In CRR, the capital is also clearly divided into two categories based on its liquidity to ensure the capital is enough to absorb possible losses. Tier 1 capital is the most "purest" form of capital that enables the institution to continue its operations and avoid insolvency. The common equity, or going concern Tier 1 capital, needs to be at least 4.5% of the total 8% capital requirement. The other form of capital, gone concern Tier 2 capital, is to help repaying senior creditors and depositors what the bank owes them if the institution fails. (European Commission 2013a, 13.)

In addition to revised capital requirements, the **CRR sets clear rules for liquidity**. European Commission memo 13/690 clarifies why new rules for liquidity are needed in the light of the recent financial crisis. The memo states that there are no harmonized regulatory treatment at EU level when it comes to standards for liquidity. This was experienced after the hard financial crisis started in the EU – many firms and banks weren't able to survive due to insufficient or poor quality liquid means. The new regulation sets **two new liquidity buffers for banks** in EU: the Liquidity Coverage Requirement (LCR) and the Net Stable Funding Requirement (NSFR). The implementation of these new requirements under the Regulation is scheduled over a four-year period starting in 2015 and reaching full force in 2018. (2013, 19). In the following graph one can see how Commission describes LCR and NSFR's key characteristics.

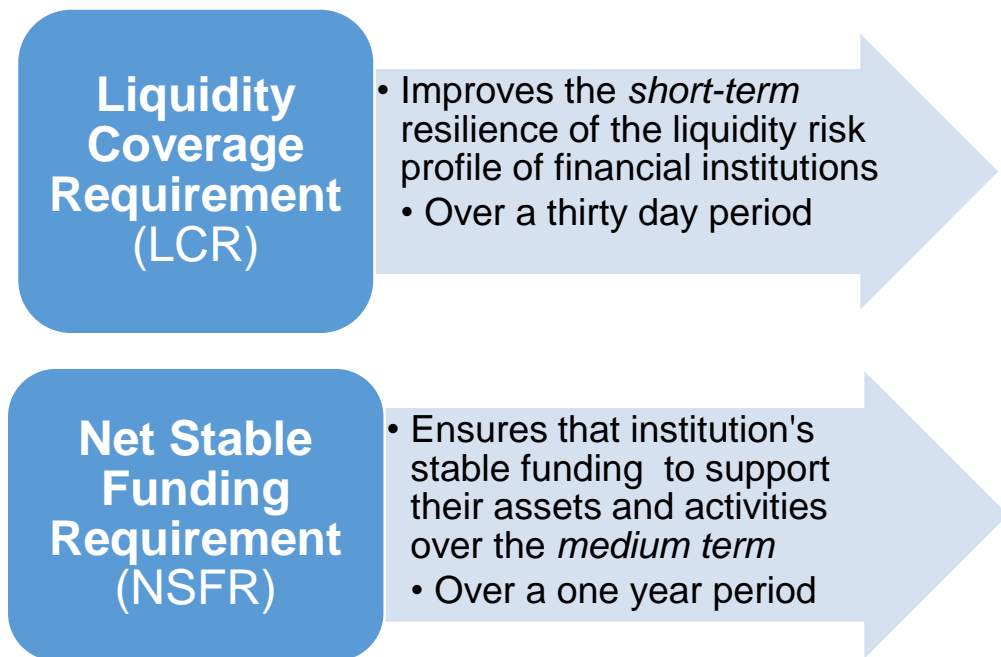


Figure 11: Key characteristics of LCR and NSFR (European Commission 2013a, 19)

Third key aspect of the new Capital Requirements Regulation, CRR, is leverage ratio. European Commission explains leverage as an “inherent part of banking activity” and it exists “as soon as an entity’s assets exceed its capital base” (2013a, 22). According to European Commission, leverage ratio as a bank regulation tool is new, and thus there is no reported data yet. However, as it is a key aspect in Basel III framework, it will be applied in EU as well. Gathering data and making needed adjustments is crucial before any binding requirements are applied. Highly leveraged institutions were playing an important part in the beginning of the latest financial crisis, as many banks had high amount of both non-risk weighted and off-balance sheet assets when compared to their capital base. The Commission memo states that European Union is not trying to eliminate leverage, but rather remove the excessive risk-taking by reducing banks’ leverage ratios. (European Commission 2013a, 22-23.)

6 How are evolving banking regulations reshaping banks' business?

As one has learned, banking regulations are affecting banks' operations on a very fundamental level: capital and liquidity ratios need to be on an acceptable level and in addition banks are required to take care of their internal governance and resolvability plans by setting additional capital buffers to be protected from insolvency. In addition, European Union implements new resolution funds in all member states through the new Single Rulebook, to serve failing banks and to protect the remaining. These are only to mention some of the new tightened regulative reforms for banking sector, and it leaves one wondering whether all banks and financial operators are capable to comply. The focus in this chapter will be on the effects of the newest set of global banking regulations.

6.1 Conceptual framework

Key words in the beginning of this thesis familiarized the reader with the concept “**three pressures**”. As indicated in the report by KPMG, these three pressures towards banks are the bank's customers, investors, and regulators. (2014, 5). After conducting a comprehensive qualitative research, my hypothesis is that these three pressures have always been part of the business environment where banks operate, but only after the beginning of the latest financial crisis, have they started to heavily reshape banks' business models through evolving banking regulations.

The sphere of evolving banking regulation raises questions and opinions all around the world among financial leaders and especially within banks. To give a comprehensive picture of the current constraints the new financial regulations are causing banks, I will be citing articles and columns from respected financial magazines, as well as other reliable material, such as guides and video material produced by well-known banks.

In this section, I want to bring my hypothesis closer to reality and see what kinds of changes bank regulations concerning capital, liquidity, and resolvability are causing in banks' operations. I will be using qualitative information I have found mainly from the secondary data sources. As an employee in Nordea Bank Finland plc, I also consider myself a suitable person for giving a valid viewpoint on how banks are balancing for example between pressures towards customers and regulators.

6.2 Changes in the business environment

It may be needless to say that not all banks are capable to meet the new requirements. According to a news article written by Deutsche Welle, the number of European banks is

rapidly decreasing (2013). Among 27 member states in the European Union, the amount on banks dropped by 5.3% from 2011 to 2012, totalling just over 9.000 banks in the end of 2012. (DW 2013). Banking sector has always been highly regulated sector, but is the rapid decrease in the number of European banks an indicator of new kind of direct inter-connection between restricted banking regulations and the survival of only the toughest banks?

According to KPMG's report on the issues and implications of Basel III, the transition from Basel II agreement to the more complex and dynamic global regulatory landscape in Basel III, is going to be arduous and time-consuming (2011, 2). KPMG suggest in their report that all banks ought to make a **roadmap for the transition**, to see how the new framework will apply to their operations, and thus become more adaptive in the process. The report shows the reader what kinds of changes and impacts are possible, and how the operations should be possibly re-evaluated to comply with the new requirements. According to KPMG, companies should implement a-five-phase plan for the Basel III implementation: 1. impact analysis, 2. evaluation of strategic options, 3. preparation, and 4. implementation. The fifth phase is ongoing monitoring and communication (2011, 14). According to the report, careful planning and implementation are crucial for a bank's success.

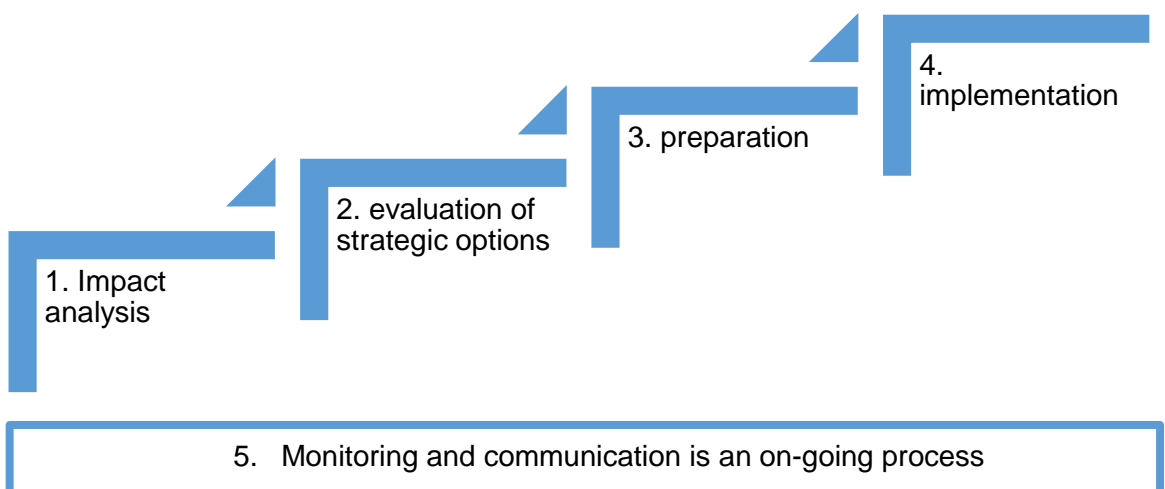


Figure 12: Roadmap for the transition (KPMG 2011, 14)

The **impact analysis**, as suggested to do by KPMG, includes identifying the key (business) areas Basel III affects. Also, assessing the ratios set in the new Basel III framework, understanding the requirements, making careful capital planning, calculating bank's risk-weighted assets (RWAs), and making earning projections are in a key role when making the bank's impact analysis. The fundamental nature of a bank obviously affects the impacts these new requirements will have – commercial banks, investor banks, and savings banks all have to assess the impacts concerning their line of business. (KPMG 2011, 14).

The **evaluation of strategic options** includes for example making suitable adjustments in the bank's line of business or products and examining the strategies concerning capital and liquidity management. In bigger banks that operate in multiple countries and even continents, this evaluation is a considerable effort, but needs to be done in order to complete the third step – preparation for implementing Basel III requirements. The **preparation** phase includes making the changes the evaluation phase brought up. Were there any deficiencies in the capital and liquidity management, for example? Are all of the reporting mechanisms working – IT infrastructure is working and the needed data can be collected for reporting? (KPMG 2011, 14). Capital and liquidity requirements are becoming stricter, and as we have learned, the risks related to insufficient capital and liquidity also concerns greatly the company's frontline employees. Is the current education of employees on a suitable level so that the employees understand their stake on the lending process? If a bank goes through its operations carefully, it will be able to notice the contradictions and make needed changes before the implementation process becomes current.

According to KPMG, the **implementation process** includes complying with liquidity, funding, and reporting standards, but also possible process redesigns. Some banks also might notice that they need to integrate or separate their business lines to comply with the new Basel III requirements. (KPMG 2011, 14). According to my own opinion, some banks might even find out that their resources and capabilities are not on a required level, and this might cause mergers and acquisitions. This also one of the reasons why **communication** with all possible stakeholders is important throughout the process, as suggested in the report by KPMG.

6.3 What are “the three pressures”?

KPMG published a comprehensive report on evolving banking regulation in February 2014. This fresh report has many view-points on the issue, and provides the reader with interesting information on how the recent changes in banking regulation affect banks and other financial institutions, in regards of pressure from and towards their customers, investors, and regulators (KPMG 2014, 5). This is a valuable view-point, as it brings my thesis topic a lot closer to the reader – new regulations in terms of capital, liquidity, stress-testing, and risk management in reality are not just endless board meetings, numbers and law terms, but they also reflect the business environment where banks operate in, and thus change the banks' operating environment.

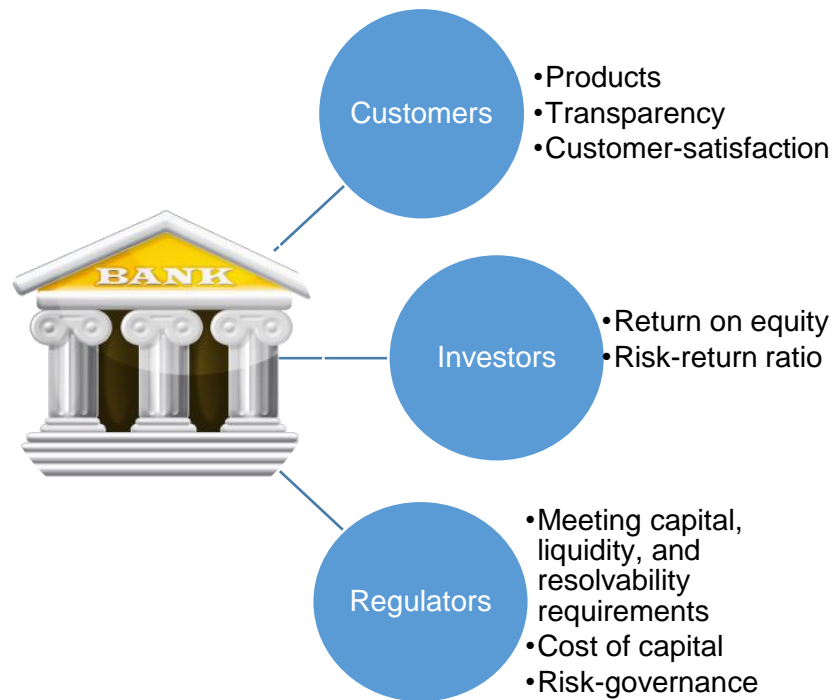


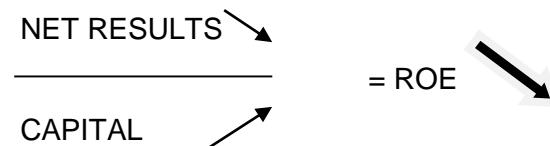
Figure 13: Current sources of pressure for banks (KPMG 2014, 5)

Figure 13 shows how banks face ever-growing pressure to and from three different sources due to stricter and evolving banking regulation. Regulators are not only passing new regulations to banks, but banks are also responsible for suitable and sufficient reporting back to the regulators and other supervisors on global and national levels. Other two important segments forming new pressures towards banks are investors and customers, such as individual families and small businesses. Private customers and investors want high-quality products, as well as sufficient return on their investments. However, to meet the new requirements regarding capital, liquidity, and resolvability, banks might be forced to make major changes in their product-offerings and prices. This again forms a growing challenge for banks to find the balance between customer-satisfaction, cost-effectiveness, and legitimacy.

6.4 Balancing operations

BNP Paribas Fortis, one of the 29 identified G-SIBs in the world, explains some of the effects Basel III has in real banking business on a 10-minute YouTube video presentation. The animated presentation is based on the initial presentation by Lars Machenil (CFO BNP Paribas) and Walter Rosenhek (Basel 3 Program Manager BNP Paribas Fortis). The video reveals how the new Basel III regulations on liquidity and stress tests affect bank's operations. I was watching the video and quoted here some important parts from the end of the video.

At all times, enough liquidity has to be available to comply with the stress test. This will put pressure on the net results. Remember also that the required increase in the capital must be set aside, so we are dividing something becoming smaller by something becoming larger. This leads to a reduction in return on equity for banks. This is a very tangible Basel III impact on banks.

$$\frac{\text{NET RESULTS}}{\text{CAPITAL}} = \text{ROE}$$


The primary challenge to a bank is the managing of the equilibrium between loans and deposits. This is a fundamental daily challenge that will drive the banks. As I have explained, banks face a profitability challenge. Revenues from cross-selling will be welcome, and on top of this cross-selling will be required to manage the equilibrium loans-deposits. However, this cross-selling also leads to more operational intimacy. (...) While managing the balance between deposits and loans, cross-selling will also be key. The operational intimacy this will bring, will help to retain required liquidity levels for the stress test. So, this is very fundamental to the required calculations for Basel III as well as for the continuity of the bank. This leads us to our statement that banks have to have complementary activities to the business granting loans and collecting deposits. Cash management is a good example. Cash management is key in this context, factoring is also a complementary activity. (YouTube Basel III 2012, 7:37-9:27.)

The video was made from an individual bank's point-of-view and it was discussing the key question banks need to ask themselves: How are we going to balance between the new banking regulations and the sustainable business? On the YouTube video, BNP Paribas Fortis was talking about the importance of "operational intimacy" created by the balance between taking deposits to granting loans combined with the right level of cross-selling. In the Figure 14, I have pictured this operational intimacy as a triangle to show how deposits in a bank form the base for the bank operations together with the granted loans. Cross-selling I see as a tip of the ice berg, complementing the base – of course noticing that without selling there are no deposits or loans. BNP Paribas Fortis was suggesting that if a bank succeeded keeping this operational intimacy by creating suitable product offerings, the bank can survive from the turbulence caused by tightening capital and liquidity requirements. (YouTube Basel III 2012, 7:37-9:27).

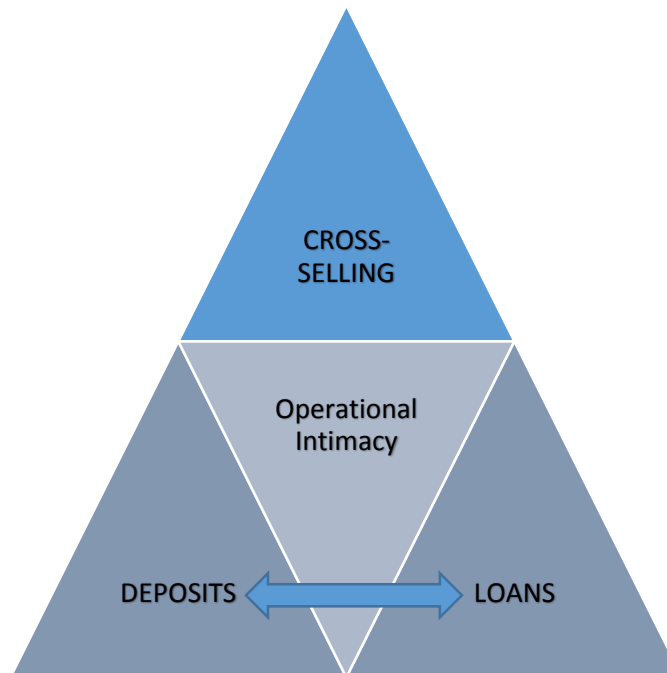


Figure 14: Operational intimacy supporting liquidity (BNP Paribas 2012)

6.4.1 The paradoxical pressure of banks towards its investors and regulators

When it comes to assessing the pressures towards investors and regulators, figure 15 below summarizes the key problem – banking is truly made safer but at the same time investors see how stricter regulations and requirements shrink the return on equity (ROE). As the figure shows, ROE took a deep dive in selected 14 G-SIBs between 2006 and 2008 from 20% to -10%. In two years, from 2008 to 2010, return on equity climbed to be around 15% again, but as the global financial crisis took a new hit in 2011-2012, the average return on equity reduced close to 0%. According to the graph, tier-1 capital ratio has been much more stable during the same time period – since 2007 the required capital level has steadily increased from 8% to 15% in 2013. (The Economist 2014). It is easy to see how this probably affects some of the investors – banks and other institutions affected by the new global financial regulations might not be seen as attractive investing targets as private companies for example.



Figure 15: Safety vs profit (The Economist 2014)

European Commission suggests in their memo how banks can increase their capital ratio to meet new capital requirements. According to the memo, increasing capital ratio can be done either by increasing capital by issuing new shares and/or not paying dividends. These acts will add retained earnings, as long as the bank does not increase their risk-weighted assets (RWAs). This also works vice versa – reducing risk-weighted assets will increase the capital ratio. Examples of this is to sell loan portfolios or reducing lending. (2013, 15.)

Safety versus profit clearly creates a paradox if banks are seeking for greater capital ratios, but investors are seeking for greater return on their own investments. If a bank is refusing to pay dividends to its shareholders, it will cause problems for the company itself, as investors can always look for better investment targets.

6.4.2 New banking regulation and its impact on end-customers

At first it may seem far-fetched, but the stricter banking regulation in terms of new liquidity standards, capital buffers, and increased risk-coverage definitely have direct impact on customers, as well. When banks need to find suitable responses to the changing regulations, rethinking pricing, funding, risks, and operations in general, are in key position. Accenture has produced a document – Basel III and its consequences: Confronting a New Regulatory Environment – and in the document they list some potential response methods

banks may find useful when trying to find ways to meet the new requirements. Accenture mentions three approaches for banks to respond for regulative changes Basel III causes: operational response, tactical response, and strategic response (2011, 7). These responses are especially useful when evaluating how end-customers of retail banks, for example, are affected. In the Figure 16 I have described how new banking regulations affects customers and through which stages it happens when banks are forced to rethink their business structures.

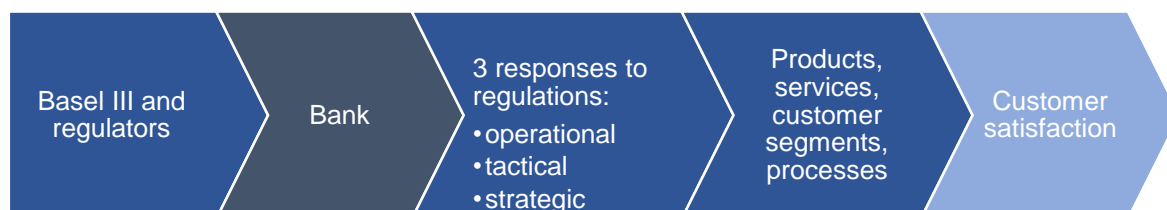


Figure 16: Evolving banking regulation and effect on customers

One of the Accenture's suggestions for potential **operational responses** to Basel III changes is stricter credit approval processes. This approach includes developing credit processes to help assessing risks more carefully. Also, taking stress tests as part of the credit process helps banks improve their liquidity risk management. (Accenture 2011, 7). This will help banks mitigating risks and comply with new levels of capital to risk-weighted assets (RWA), but for individual customers it may simply mean lower credit limits and longer waiting periods for getting loan applications approved.

More far-reaching **tactical responses** according to Accenture include for example pricing, funding, and asset reconstructing that have effect on a bank's profitability. These methods include adjusting lending rates, adjusting risk-sensitive pricing to match with banks' higher capital and liquidity costs, and shifting to higher-value clients. (2011, 7.) It is clear that these adjustments are easily implementable for banks, but it may be resulting in customer dissatisfaction. Short-term lending, such as unsecured consumer credits issued for less than three years, are becoming more and more expensive all the time, as banks face pressure for bigger and more liquid capital reserves that are weighted against risks. However, for consumers, especially for consumers who can't provide bank any securities, this type of loans are important for making bigger purchases.

Also, when banks face ever-growing pressure from regulators in terms of capital and profitability, banks are tempted to start making radical strategic changes. According to Accenture, this response method to changing banking regulation is called **strategic response**. It may mean for example starting to concentrate on higher-value customers and make other

strategic cost reductions, such outsourcing non-core business functions (2001, 8). These methods are more far-reaching possibilities to have an effect on banks' capital ratio, but they are as effective as straight-forward methods, such as retaining earning or issuing new shares. However, strategic changes usually require complex decisions and if banks decide to make strategic readjustments, such as adjusting client segmentation and devoting less resources on specific segments in order to create stronger capital risk structures, they need to be aware the consequences to customer satisfaction for example. (Accenture 2011, 8, 13.) Closing branch offices and reducing business hours for serving clients ad hoc are also some clear examples of banks' strategic responses to new bank regulations, especially to Basel III.

7 Conclusion

7.1 The future of European banks

As one has learned, there are a number of changes the European banking sector is facing currently in regards of banking regulation. Basel Committee on Banking Supervision is working hard for developing existing Basel frameworks and providing banks around the world with the new framework, Basel III. The recent financial crisis has woken up the sceptics and supporters of financial regulation, but on a European level banks have no room for neglecting compliance with regulations. Gtnews, part of the Association for Financial Professionals, has produced a Guide to Impact of Regulation on Cash and Trade together with Nordea Bank. The guide stresses the importance of pro-active approach to the evolving banking regulation and raises awareness on how regulatory changes are often viewed as another cost of doing business (gtnews 2014, 1). Having read the document, I could argue it is often about the banks' attitude toward the change, even when it comes to legal issues and compliance. The guide implies that as the landscape of regulation is always changing, banks could use the changing business environment to identify opportunities for greater efficiency and risk-management. Take for example new liquidity and capital requirements: to meet the new regulations, banks need to improve their internal processes to achieve better pricing and risk-management systems and through understanding the bank's revenue generating model they are better able to adjust the product offering for compliance of regulations **and** for more efficient revenue stream. According to Gtnews, "the changes are often by-products of regulations that are targeted at making the banking system more robust, primarily for the benefit of retail customers" (2014, 1).

In the previous chapters I have given some examples how banks are affected by the regulative changes in terms of capital adequacy, liquidity, and resolvability. It is clear that the pressures from various sources are greater than ever before, and some banks fail to meet the new requirements. In some cases, evolving banking regulation causes weaker banks to find themselves in a situation where their business is not profitable anymore. According to an article on Taloussanomat, Björn Wahlroos, the Chairman of the Board for Nordea Bank, said in the panel discussion Tulevaisuuden Suomi held in Helsinki on October 2014, that regulation is good for large corporations as it is one of their competitive advantages. (2014). He implied especially bigger banks' larger resources to comply with the new regulations and thus his comment is truly justified. However, I believe that even some smaller banks who can truly understand the drivers behind the current regulatory changes can gain leverage to some larger banks by finding new cost-efficient and even innovative

ways to improve their business models and this way comply with the upcoming regulations. A good way for any European bank to find these hidden possibilities and success behind evolving banking regulations, is to follow KPMG's suggestion to make a comprehensive transformation roadmap. Especially important this is when banks are fighting their way out of clarifying how new Basel III regulations are affecting their operations now and in the near future. (KPMG 2011).

7.2 Own learning and relation to professional growth

As a corporate banking advisor in Nordea Bank Finland, I can underwrite the statement BNP Paribas Bank made about operational intimacy. It is strategically important for commercial banks to adapt into changing business environment by setting the goals for cross-selling and for balanced deposits and loans to meet the new required levels for liquidity and capital. This naturally reflects to product-offerings, prices, and customer service. As a front-end employee working directly with own assigned corporate customers, I am responsible for providing banking services that supports the bank's strategy that fulfils all new banking regulations, such as CRDIV/CRR provisions for added capital buffers and liquidity, risk-management, and reporting standards. The changes in the banking regulations seem straight-forward on a paper, but as one has learned, there are detailed and complex legislative background to new banking regulations before they are applied in banks' operations. Changing banking regulations heavily reflect on our way of working – knowing your customer is the base for all banking services and this relates to the new compliance requirements. The new capital and liquidity requirements reflect not only on the price tag for lending, but also to the very base line – developing sufficient IT infrastructure and other tools to help employees grant loans at the right price when considering risks, sustainability, and capital planning. The effects are great for banks and all operators willing to continue sustainable business need to rethink all services and prices so that the continuity of a bank can be ensured.

I have learned a great deal during this research and writing phase, and the topic has evolved when my understanding on the topic has grown. There are a number of interesting view-points that could be used as a research question, but this is only a beginning for my research. I am aiming to continue for a Master's Degree in Aalto University and hope to take this topic on a new level by providing some financial institution a detailed plan on how to tackle new requirements and find possible competitive advantages behind new rules and regulations. I believe my deepened understanding and interest on the whole banking regulatory spectrum is on level that will give me an edge to continue my career in some specialist position in the future.

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